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What Role should the ECB Play in Financial Market Supervision¹

Anne Sibert
Birkbeck, University of London and CEPR

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Executive Summary

- The General Council of the ESCB should be the forum where the macro-prudential financial supervision policies of the EU central banks should be discussed and decided.
- Article 105(6) should be amended. The words "... with the exception of insurance undertakings" should be removed.
- If the ECB were to be given greater responsibility and authority in the area of macro-prudential supervision, then it must be required to be less independent and more accountable than it is when making monetary policy.
- It is difficult for the ECB to take a larger macro-prudential financial stability role before the issue of how the Eurosystem is to be recapitalised in the event of capital losses realised while the ECB plays this role is addressed and resolved.

1. The General Council of the ESCB should be the forum where the macro-prudential financial supervision policies of the EU central banks should be discussed and decided

Article 105(1) of the Treaty emphasises that the principle role of the ESCB is the provision of stable prices:

The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 3a.

¹ Briefing paper prepared for the Committee on Economic and Monetary Affairs of the European Parliament for the quarterly dialogue with the President of the European Central Bank.

Until the emergence of the credit crisis on 9 August 2007, the ECB and the ESCB played no important role in the supervision and regulation of financial institutions or markets. With the surfacing of the global financial crisis in September 2008, however, it became apparent that a broader role for the ECB and ESCB might be desirable. The door has been left open for this in Articles 105(5) and 105(6) of the Treaty. Article 105(5) states

The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the Financial system.

Article 105(6) says

The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.

In his introductory remarks for the first quarter 2009 Monetary Dialogue with the European Parliament, Jean-Claude Trichet referred to Article 105(6) and said, “Reflections have started on the specific role that could be played by the ECB and its Governing Council should this provision of the Treaty be activated.” President Trichet’s referral to Article 105(6), rather than Article 105(5) is somewhat perplexing.

Article 105(5) is more important to the future of EU financial supervision and regulation than Article 105(6) because it addresses the ESCB, which speaks for the entire EU and not just the euro zone: the General Council of the ESCB is made up of the President and the Vice President of the ECB plus the Governors of the 27 EU national central banks – including the 11 national central banks that are not part of the euro zone. From the point of view of the EU as a whole, the General Council of the ESCB – not the ECB – should be the forum where the macro-prudential financial supervision policies of EU central banks should be discussed and decided.

It is important to note that Article 105(6) allows the Council, the Commission and the European Parliament to grant the ECB specific prudential supervision tasks. The article does not, however, mention any regulatory tasks. This distinction between a supervisory role (enforcing the rules) and a regulatory role (making the rules) is an important one.

2. Article 105(6) should be amended to include insurance

The exclusion of insurance from the potential supervisory remit of the ECB is unfortunate: perhaps even more than the 14 September 2008 collapse of Lehman Brothers, it was the failure of American International Group (AIG) two days later that marked the beginning of the global financial crisis. AIG (the subject of the largest government bailout of a private company in US history) is a global insurance company with a balance sheet of more than a trillion dollars – the 18th largest publicly owned company in the world in 2008. Regulated by the New York State Regulator of Insurance, it developed a rogue investment banking unit that sold credit

default swaps out of sight of the Fed, the FDIC or the SEC.² As Fed Chairman Bernanke, commented, “A.I.G. exploited a huge gap in the regulatory system. There was no oversight of the financial products division. This was a hedge fund, basically, that was attached to a large and stable insurance company.”³

In addition to AIG, insurance companies across Europe and the United States have been engaged in excessive financial innovation and credit exposure. On 28 October 2008, the Dutch Ministry of Finance and De Nederlandsche Bank injected 3 billion euros of capital into the AEGON Group, one of the world’s largest suppliers of life insurance, investments and pensions. Moody’s, Standard & Poor and A. M. Best have all downgraded Swiss Re, with A. M. Best commenting that “Swiss Re’s overall risk-adjusted capitalization does not have sufficient cushion to weather more negative effects of the continuing turmoil in the financial markets and other unexpected events.”⁴ The problems with Fortis Group affected its insurance, as well as its banking units. The list of troubled insurance companies is lengthening. Clearly, many insurance companies have encountered problems similar to those encountered by other highly leveraged institutions and it is important that large cross-border insurance companies be included in any EU-wide supervisor or regulator’s remit.

3. The ECB is excessively independent and not accountable enough to be a financial market supervisor

The ECB is probably the most independent central bank in the world and this is the main obstacle to it being a financial supervisor. No government or government agency – national or supranational – can tell it what to do. Its Executive Board members and the heads of the national central banks cannot be fired except for gross misconduct. (Gross incompetence will not do.) The ECB is more than operationally independent: it gets to choose the definition of price stability. This is unusual among modern central banks: the government chooses the inflation target for the Bank of England and Norges Bank; the Bank of Canada and the Reserve Bank of New Zealand agree a definition of price stability with the government.

The ECB’s independence has resulted in a lack of accountability. A perusal of its website shows that to the ECB, “accountability” is synonymous with “reporting obligations”. It appears to believe that it fulfils its accountability obligations by publishing its annual report, monthly bulletin, consolidated weekly financial statements and some task-related publications.⁵ Fulfilling one’s reporting obligations is only a necessary condition for accountability. Real accountability also requires that those who hold you responsible can reward or punish you for your actions. The

² The New York State Department of Insurance was out of its depth, insisting in late August 2008 that, “AIG continues to meet New York’s solvency standards, and is able to honor its obligations to policyholders.” (spokesman quoted in “Is your insurance safe with AIG?” *Wall Street Journal*, 22 Aug 2008.)

³ Quoted in Stout, David and Brian Knowlton, “Fed chief says insurance giant acted irresponsibly,” *New York Times*, 3 Mar 2009.

⁴ Quoted in “Best downgrades Swiss Re’s ratings,” *Insurance Journal*, 2 Mar 2009.

⁵ The ECB’s terse description of accountability can be found on its website by clicking successively on “European Central Bank”, “Organisation” and “Accountability”. Its rather more enthusiastic description of its independence is found under “Organisation” as well.

extreme independence of the ECB means that in practice, it has no real accountability.⁶

In its defense of its independence on its website, the ECB says, “The independence of the ECB is conducive to maintaining price stability. This is supported by extensive theoretical analysis and empirical evidence on central bank independence.” The ECB is likely correct in this assertion, but the supervision of financial institutions and the provision of stable financial markets is an inherently political activity – involving a substantial redistribution of income – and is not consistent with a lack of answerability. Thus, if the ECB were to be given significant supervisory powers then the nature of the ECB must change. Those officials of the ECB involved in supervision must be substantively accountable with regard to this activity.

4. This issue of funding must be addressed

The current crisis reminds us that a central bank without adequate fiscal backing can be powerless in the pursuit of macro-prudential stability and even in the pursuit of price stability. That fiscal backing for the central bank might be a necessary condition for the central bank to achieve price stability was not an issue for the ECB until the current crisis. However, as the crisis has deepened, the exposure of the ECB/Eurosystem to private credit risk through its exposure to repos and other collateralised lending has become a pressing issue. Defaults from the German arm of Lehman Brothers Holding and three Icelandic bank subsidiaries were among the reasons the ECB reported recently that it is owed more than 10 billion euros by various counterparties. Even though the insolvent counterparties had submitted eligible collateral in return for ECB funding, their collateral, which mainly consisted of asset-backed securities, was in the words of an ECB press release “... of limited liquidity under the present exceptional market conditions and some of the [asset-backed securities] need to be restructured in order to allow for efficient recovery, ...”.

If the ECB’s policy rate nears zero, the ECB may have to engage in quantitative and qualitative easing: the outright purchase of private securities funded by an increase in the monetary base. Without a fiscal indemnification for the resulting credit risk, the ECB will be unable to address the excessive private-public yield spreads and the credit rationing that are symptoms of dysfunctional credit markets. The Bank of England can turn to HM Treasury and the Fed can turn to the US Treasury, but to what body does the ECB turn to for fiscal backing? Is it the 16 euro zone Treasuries or ministries of finance? Or the 27 EU Treasuries or ministries of finance that are the shareholders of the ECB? Currently there is a vacuum behind the ECB and the Eurosystem with respect to losses incurred by the Eurosystem as a result of monetary operations, liquidity interventions and credit-easing policies. While obviously politically difficult, this is a problem that needs to be addressed urgently.

⁶ An example that reveals the ECB’s stance on accountability was its attitude toward the Committee on Economic and Monetary Affairs of the European Parliament when the Committee expressed concerns about the ECB’s lack of procedural transparency during its quarterly dialogue with the ECB. For years members pressed unsuccessfully for details about the decision-making process, without engaging the ECB’s representative in serious discussion. (See Sibert, Anne, “The European Parliament’s quarterly dialogue with the ECB and its panel of experts,” briefing paper prepared for the Committee on Economic and Monetary Affairs of the European Parliament, Oct 2005.)